ISLAMIC BANKING & FINANCE

ANOTHER APPROACH

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Islamic Banking and Finance: Another Approach

by

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In recent years a series of three books has been published on the above subject. Each book is self-contained, treats a specific topic, and presents a new methodology. However, taken together, they provide a comprehensive banking and financing system that addresses the needs and concerns of Muslims today. Their titles speak for themselves: *Interest-free Commercial Banking, Participatory Financing through Investment Banks and Commercial Banks,* and *Commercial Banking in the presence of Inflation.* In this article we propose to give an overview of this new approach.

1. Main features

The salient features of the proposed system are: 1) There is no interest on deposits, but capital is guaranteed. 2) Lending and investing are treated differently; loans are interest-free but carry a service charge, while investing is on a profit-and-loss-sharing (*mudaraba*) basis. Commercial banks will grant loans but they will not engage in investment-financing.[1] Investment-

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[1] There are circumstances where it is socially or economically desirable and commercially viable for commercial banks to engage in financing. This system makes allowance for it under defined conditions. But this is an option that need not be exercised.

financing will be done through investment banks and investment companies. 3) Value erosion of capital due to inflation is compensated.

With these features the proposed system simply *avoids* the many problems faced by Islamic banking as practised today, including its inability to set up and operate interest-free banks in most countries of the world. The problem of inflation is not explicitly treated by any system of banking, but it is a general problem and is treated as such in the third book. The system can be considered as consisting of several independent modules. And, one or more could be implemented at a time, according to the requirements of a given situation. We will expand on these topics in the following sections.

As far as commercial banking is concerned, there are two major departures from the traditional approaches (conventional or Islamic), and these are very important developments. One is that this system considers commercial banks as service providers, instead of as "money lenders" (conventional) or "investment-partners" (Islamic). Two, the books present a general model of commercial bank lending process, and interest-free banking is derived as a sub-model; the conventional banking is seen as an "inflation-free" sub-model of the general model. These departures enable one to eliminate *riba* from the system without resorting to drastic measures, and still have a fully viable system compatible with the conventional one. In turn, this compatibility makes the new system easy to understand and to explain, and therefore easy to implement in all countries. The philosophical re-orientation, procedural adjustments, and the re-training of staff required for the change over from the conventional to the proposed system are also minimal. More importantly, the new approach makes commercial banking transparent, interest-free or not.

2. Zero interest and capital guarantee

Muslims are prohibited by their religion to deal in interest (*riba*) in any way. Giving and receiving as well as witnessing are all prohibited. Thus an Islamic banking system cannot pay any interest to its depositors; neither can it demand or receive any interest from the borrowers. Nor could the banks witness or keep accounts of these transactions. But the lender is entitled to the return of his capital in full. This is a Qur'anic injunction.[2] The proposed system complies with these fundamental Islamic requirements.

A basic tenet of commercial banking is capital guarantee. The capital entrusted to the bank by a depositor must be returned to him in full. The proposed system fully complies with this requirement. Islamic banking as practised today does not provide capital guarantee in all its deposit accounts. In many countries, this is one of the two main objections to permitting the establishment of Islamic banks. There is no objection to paying zero interest on deposits.

Thus, by paying zero interest and guaranteeing capital, the proposed system satisfies both the *riba*-prohibition rule of Islam and the capital guarantee requirement of conventional Banking Acts. This enables it to obtain permission to set up and operate as a deposit bank in all countries of the world, while obeying the *riba*-prohibition rule and qualifying to be an "Islamic" bank. This is of paramount importance to Muslim minorities living in non-Muslim countries. Furthermore, the existence of interest-free banks in all countries will also remove the many difficulties faced today by Islamic banks in transacting international business.

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[2] Qur'an, 2:279.

3. Lending and investing

In conventional banking, depositing is a form of investment for the savers where the capital remains intact while a known income (in the form of interest) is promised. To the banks lending is a form of investment where the capital and a known return are assured; the return will also cover all their costs. Since Islam prohibits dealing in interest in any form this type of banking is not acceptable to the Muslims.

In Islam, there is a clear difference between lending and investing — lending can be done only on the basis of zero interest and capital guarantee, and investing only on the basis of *mudaraba* (profit-and-loss-sharing). Conventional banking does not — and need not — make this differentiation. But an Islamic bank has to take this into consideration in devising a system to cater to the Muslims. Therefore such a system has to provide for two sub-systems — one to cater to those who would "lend" and another for those who wish to invest.

In the proposed system, the depositors are considered as lenders to the bank and, since a Muslim lender cannot receive any interest, he lends without interest but with the assurance that his capital will be returned in full. This applies to demand (current account) deposits as well as to savings deposits. The bank, in turn, lends (the depositors' funds) to the borrower who should return the capital in full plus the costs of the bank's services and a remuneration (or profit) to the bank for providing these services. This suits some depositors and some borrowers. The first book — *Interest-free Commercial Banking* — is concerned with this group of people.[3] The theory and method are fully explained in the book.

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[3] We will expand on this group later on.

The second objection to Islamic banks as they operate today is that their assets are not readily assessable (since they are tied up in equity-type investments where neither capital nor return are guaranteed), and to put a reasonable value on these assets will require enormous amounts of effort and experience. In the proposed system, the depositors' capital and return (*albeit* zero) are guaranteed; and the bank's assets are also guaranteed and their costs are fully covered; and the accounting procedures are well defined and uncomplicated. As such the bank's assets are assessable. Therefore the proposed method should attract no objection from any banking authority, thereby enabling interest-free (or Islamic) banks to be set up in all countries of the world.

In conventional banking those who wish to earn an income using their savings do so by putting their capital in savings deposits or time (fixed) deposits and receive an interest payment. A Muslim cannot earn an income by this means. He has to *participate* in a project by financing it and by sharing in its loss or profit. The participatory financing described in the next section is devised to cater to this group.

4. Participatory financing

The second book, *Participatory Financing through Investment Banks and Commercial Banks,* provides the mechanics of a financing scheme that would cater to the needs of those Muslim capital-holders who wish to earn an income using their capital without involving themselves in *riba*. The Islamic option for this group is the concept called *mudaraba,* which is usually translated as profit-and-loss-sharing but is in fact profit-sharing-and-loss-absorbing, and in this book it is named as participatory financing. The basic idea is that two parties, one with capital and the other with know-how, get

together to carry out a project. If the project ends in profit they share the profit in a pre-arranged proportion; if it results in loss the entire loss is borne by the financier. There are many variations of this simple model but this is the basic concept.

The book provides a general mechanism for the implementation of this concept, examines various different situations that occur in real life, and shows how the same mechanism can be modified to suit each situation. The situations range from the simple two-person model and the slightly more complex one-project-many-investors case, to one where an intermediary comes in, to accept capital from several investors for investing in many different enterprises and then to collect and distribute the profit/loss to the investors. The intermediaries may range from small local investment companies to large-scale multinationals, and from investment banks to commercial banks. And the investors may range from small-time individual savers to institutional savers and millionaires. The projects too may vary from small one-person enterprises to multimillion projects by very large companies. And the projects may last for a short limited period or continue for a very long time.

The investor is essentially a sleeping partner. He provides the financing and then shares the profit or absorbs the loss. It is the responsibility of the entrepreneur to present a good project proposal, convince the financier that it is viable and profitable, and provide proof that he is able, qualified and experienced to carry out the project successfully. The intermediary is at once both an entrepreneur and a financier. When he accepts funds from an investor, he is an entrepreneur; and when he finances a project submitted by an entrepreneur, he is a financier.

The function of the intermediary is very important. He is responsible for identifying good projects for financing as well as for monitoring its progress and ensuring its proper accounting and auditing. But he (the intermediary) plays no part in managing the project or in making policy decisions — that is the exclusive domain of the entrepreneur. The intermediary is a separate physical and legal entity, independent of both the investors and the entrepreneurs. But he (she/it) is an equal partner in every project he finances so that he has full legal right to the physical and financial assets of all the projects and has full access to all the books. This is very important, and it is here that participatory financing differs from conventional financing practices; in this respect it differs from the current practices of Islamic banks too. It allows the intermediary to have a true picture of the health of the project at all times. He can then take any preventive or corrective action (in extreme cases), and, in the event of the failure of a project, he can recover whatever is left of it. This arrangement assures the investors that their investment is safe and that the profit and loss account given to them are reliable and transparent. The fact that the investors' confidence and the intermediary's own profit depends on the number and size of the successful projects should ensure that the intermediary seeks out good projects and closely monitors their progress.

The proposed scheme provides for two types of investments: one called Participatory Financing (PF) stocks and the other PF shares. These are essentially stocks and shares in the intermediary's PF scheme (which is a collection of all (or a group of) the projects financed by the intermediary), and they roughly correspond to short- and long-term fixed deposit accounts. The main difference is that the return is computed from the profit and loss statements of all the projects in the PF scheme (and the profit/loss shared among the participants) at

the end of the accounting period. Therefore the profit/loss is a *realised* one, and not an anticipated or a pre-fixed one. Thus neither speculation, nor uncertainty, nor *riba* is involved in the operation.

Islamic Banking actually took root in 1975 with the establishment of the Islamic Development Bank, an inter-governmental bank; and the Dubai Islamic Bank, a private one. The question of establishing interest-free banks and thus freeing the Islamic economies from *riba* had exercised the minds of Muslim thinkers for the better part of this century. But the immediate impetus for their establishment was the excess cash the oil-rich middle-eastern countries earned following the 1973 oil-price hike. Thus the primary need for these banks was the investment aspect of banking, and not the transaction (i.e. current account operations) aspect. The author believes that an Islamic banking system should separate these two aspects of banking and devise two separate schemes appropriate to the different requirements. It is the failure to do so that has resulted in Islamic banking facing the problems it faces today. The second book —*Participatory Financing through Investment Banks and Commercial Banks*— provides for the needs of this group of people — those who posses capital and wish to use it to earn an income, but without involving in *riba*.

There are Muslim capital-owners in all countries, ranging from those in the oil-rich countries and the very rich in all countries, possessing millions and billions, to the small timers in every country and those in the rich non-Muslim countries living in small communities. Each will find a suitable spot in this participatory financing scheme, which spans a large spectrum of different situations. One end of this spectrum is really micro-level financing and the other end encompasses international financing.

One important feature of participatory financing is that the entrepreneur need not provide security for the financing he receives. The project itself is the security, and the intermediary, being an equal partner in the enterprise, is its guardian. This should play a very constructive role in discovering and developing new entrepreneurial and other talents in the society, especially at the micro level.

4.1 Financing by lending

Traditionally, commercial banks performed two functions: money transfer services, including all current account operations, and money lending. The latter brought in the major part of the bank's income while the former enabled it to "create" money and to lend more money than it actually possessed. The primary concerns of the bank were the security of its capital and the ability of the borrower to pay the interest — not the end use of the lent money. Whether it was intended for establishing a new enterprise, to expand an existing one, to bridge a cash flow problem of a running concern, or to be used by a small business, by a sole-owner enterprise, or for consumption purposes, etc. was not the prime concern of the bank. Neither did it matter whether or how the borrower kept his accounts. The borrower must pay back all the capital and the pre-fixed amount of interest, no matter how he achieved that. In the case of Islamic banks, however, the end use mattered because the return on their "investment" (they do not lend) depended on how the profit/loss was achieved and how it was computed.[4] The questions of true and proper bookkeeping by the borrowers (or entrepreneurs) and the auditing of these

[4] In fact, some Islamic banks are expected to provide consumption loans free of charge and cover their costs from the profits of their investment activities.

accounts, and that of determining the actual profit/loss directly attributable to the investment by the bank are still being debated. The inherent inability to resolve these questions is at the bottom of many of the problems faced by Islamic banks. Devices adopted to overcome these problems have only led to uneasy questions of morality.

In the proposed system, only the financing of *new* enterprises is recognised as amenable to *mudaraba*-type financing. The fact that the intermediary becomes an equal partner in the new enterprise *avoids* the difficulties caused by the above questions. All other types of end uses must be financed by loans from commercial banks, which would recover their costs and profit from the borrowers. We will look at some features of this "Islamic" or interest-free commercial banking in the next section.

5. Interest-free commercial banking

As we saw earlier, commercial banks performed two functions: money transfer services (including all current account operations) and money lending. In general, the former does not involve any interest. On the other side of the balance sheet, we have two types of deposits: current account (demand) deposits and savings deposits. Here too, the former generally does not involve any interest. Therefore current account operations and money transfer operations are free of *riba* on both sides of the balance sheet. As such all commercial banks are interest-free banks with respect to these operations.

The problem, then, arises only in respect of savings deposits on the one side and loans on the other, because both incur interest. The question of lending and accepting savings deposits, without dealing in interest (*riba*), is dealt with in the first book — *Interest-free Commercial Banking*. In this section

we will give an overview of the approach. Details are to be found in the book. The book, however, takes it for granted that Muslims *do* wish to avoid dealing in interest in order to comply with their religious belief, and limits itself to finding a simple, logical and easily executable methodology of achieving this objective. It does not concern itself with providing a justification or philosophy for the prohibition. Nor with the subtle differences and related discussions regarding the correct definition of *riba*. It simply accepts the commonly understood meaning of it — that any money demanded or received by the lender in addition to his original capital is *riba* — and proceeds from there. The resulting system, therefore, is practicable irrespective of why one wishes to avoid dealing in interest. For there are also people who are convinced for various reasons that demanding or receiving interest is bad.

The approach adopted is to "first take a closer look at modern banking practices and find out whether and where the prohibited *riba* (interest) occurred and then to see whether it could be eliminated from the existing practices and then to check if the resulting system was still viable."

On the deposit side, what the depositor receives in addition to his capital is the interest. This is *riba* (pure interest) by definition. If a Muslim refuses this interest because it is prohibited by his religion, then this side of the balance sheet is free of *riba*. On the other side of the balance sheet, we have the "interest" collected by the bank from the borrower. Ideally, the bank uses the funds it receives from depositors to grant loans to clients. But the "interest" it charges the borrowers is more than the interest it pays the depositors. This is because the former should also cover, besides the interest paid to the depositor, the costs the bank incurs in collecting and disbursing the funds as well as in accounting, administration, safekeeping, etc.

A model is constructed where the "interest" charged by the bank is split into several components. Then each of these components is studied to see if it contained the prohibited *riba*. The idea is that if any one component contained such *riba* then to see if it could be removed. If some components are free of *riba*, and others containing *riba* can be removed, then we have an "interest" which is free of *riba*. If this can be achieved and if the resulting system is viable, then we have a *riba*-free system that is also viable. And, since it was originally derived from the conventional model it should also be compatible with it.

This "interest" collected by the bank from the borrower is a cost to the borrower, of obtaining this amount of financing. Therefore, it is named the Cost of Borrowing (CoB) and is considered as consisting of six components: interest (paid to the depositor), services cost, overheads cost, risk premium, profit, and compensation for the value erosion of capital due to inflation.[5] It is shown that only the first component falls under the definition of *riba* and all others are free of it. Since the population the book is concerned with refuse to accept any interest paid by the bank (on religious or other grounds) the bank need not collect this component from the borrower. Thus this CoB is free of interest, despite the fact that it looks like the conventional "interest".[6] Consequently, the whole commercial banking system becomes *riba*-free.

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[5] In order to be able to compare the proposed system with the conventional and Islamic systems, which do not treat inflation specifically, and because the necessarily extensive treatment of this subject might detract the main thesis of the book, the last component is assumed zero in this book. It is taken up further in the third book and integrated into the system.

[6] A graphic description of how and why these cost components come about, and how one or more will disappear under different conditions, and how all will become zero in person-to-person transactions, is given in the book. It is

This is the essence of the thesis presented in the book. A description of each of the components, the method of their computation, how to implement the system, the advantages and consequences, and a whole lot of other necessary details are given in the book. It also provides an analytical method that can be used to test any lending scheme to see if it is *riba*-free or not.

In countries such as Pakistan, Iran and the Sudan where interest-free banking is mandatory, the system described in this section will be immediately relevant and will overcome all the problems the current practices in these countries find it difficult to solve. All that an existing bank has to do to change over to this system is to adopt the accounting system proposed in the book.

We have already seen that this system should face no objection from banking authorities in non-Muslim countries, and since it is compatible with the conventional system it is easy to set up and operate such banks with the minimum of delay and difficulties (including staff training). Furthermore, unlike the conventional system, this system is transparent, rests on a firm theoretical foundation, and provides management information that is very useful for effective monitoring and control. The last is a very useful tool both to the concerned bank's internal management and to the Central Bank authorities.

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interesting to note that what existed in the Mecca and Medina of 1500 ago, and discussed in the Qur'an and Hadith, are such person-to-person lending and borrowing. This situation continues to exist today too. On the other hand, CoB on Inter-bank loans, for example, will be simply the overheads cost component. Hence the model introduced in the book is a general one, which covers both the past and (a variety of) present situations.

5.1 Loan default insurance

The risk premium is one of the six components of the cost of borrowing. In conventional banking, the risk premium against default and delays is included in the interest and the bank bears the risk. The interest rate increases as the probability of risk increases; high-risk advances (such as unsecured loans) bearing a higher interest rate than low-risk ones. The model used in this book separates out this component, and proposes that it be a premium contribution to a *collective* insurance scheme, administered by a separate entity. Every borrower in any bank (in the scheme) is a member of this scheme for the duration of his loan. The premium depends on the amount of the loan, and not on the repayment period. The premiums paid by the members go into a collective fund. Any loss suffered by a member-bank due to bad loans is made good from this fund. On complete repayment of a loan the borrower will be paid part of his premium, after allowing for the administrative costs of the scheme and reimbursements to the banks (which depends on the number and size of defaults) during the period of his membership in the scheme, and proportionate to his contribution to the fund.

This is a novel proposal, and has three main beneficial consequences. One, this takes away any risk the bank runs due to non-payment of loans; thus making the bank a pure service provider. Then commercial banking becomes a service industry in the true sense. And, the burden of repayment is justifiably shifted to the borrower. Two, since the recovery of the loans are guaranteed the depositors are automatically assured of their capital. This obviates the need for deposit insurance.[7] Three, there is an ongoing debate among Islamic

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[7] See Galbraith (1992) for some interesting observations on the consequences of deposit insurance.

scholars about the propriety of imposing a fine on a defaulting or delaying borrower, by the bank, fearing that it may amount to *riba*. In such cases the banks are expected to resort to the courts, which have powers to recover the amount due and/or impose a fine. But this is a costly and time-consuming process that can be misused. The new suggestion shifts that burden to the insurance company. They may have a credit-rating scheme, and each applicant for a loan may be assigned a premium depending on his past record. Defaulters may even be refused cover.

6. Participatory financing through commercial banks

Commercial banks enjoy a privilege that investment banks and investment companies do not. They are able to "create" money which privilege they acquire through their current account operations. The process, called credit creation, is explained in the second book in an appendix. Briefly, it means that commercial banks can lend more money than they actually have in their custody. How much more depends on the particular circumstances of the concerned bank, but it can be anywhere from five to nine times. This is also called financing with bank money. A methodology has been developed in this book, where this ability is combined with the concepts of investment accounts (introduced by Islamic banks) and the *mudaraba* participation, to produce participatory financing through commercial banks. This will enable commercial banks to participate-finance many more projects than investment banks or investment companies could do with the same amount of money. But this is a new concept traditional banks are not equipped for. Bankers who wish to engage in this activity will have to have entrepreneurial talents and they have to acquire the necessary skills and cultivate suitable attitudes.

The concept, mechanism and application as well as concerns and cautions are extensively discussed in the book. But what is appropriate to say here is that this will allow low-yield and/or long-duration projects, which will be unattractive to investment banks and companies, also to be commercially financed. A two-percent return on a 100,000 project is not very attractive. It is even less attractive if the profit is to be shared by three participants. But a commercial bank can finance this on the strength of a 20,000 deposit in the investment account, if it had a credit creation factor of 5. So, even if the project made only a two percent profit on the investment of 100,000, the resulting 2000 would still be a 10 percent profit on the original 20,000 deposit. On a factor of nine it would be a staggering 18 percent. Suppose the three participants — the investor, the bank and the entrepreneur — had originally agreed on an equal share of the profit, the investor would then receive a six-percent return on his investment. Thus an unattractive 2-percent-yield project can be made a very profitable one if financed through a commercial bank.

Such (unattractive) enterprises are socially and economically the most necessary ones, especially at the micro level; ones that bring direct benefit to people at the periphery — in the villages, in the small towns, and in the slums of large cities. This is an instrument that can be used to *commercially* finance social and economic development where it is most needed and will be most appreciated — at the grass roots level.

However, introducing participatory financing into commercial banking is asking it to shoulder extra burdens, including specialised staff training and additional risks. Conventional commercial banks are prohibited from directly investing in commercial enterprises, and hence they will not be able to offer participatory financing. In countries where Islamic banks are permitted to operate this should be no

problem, provided the banks are prepared to take on the extra burdens, which of course, will bring them extra profits. They may consider setting up investment companies as fully owned subsidiaries of local branches.

7. Compensation for inflation

In the last few decades, inflation seems to have become a permanent feature of all economies, especially of developing economies. This has a devastating effect on those who save money. If they keep it at home as cash, its value is eroded daily by inflation. If a friend borrowed it, its purchasing power is reduced when he returns it. If they deposit their savings with a bank, its value, when they withdraw it after some time, is much reduced. Sometimes the interest rate payable to the depositors lacks so behind the inflation rate that the combined purchasing power of the capital and interest is less than that of the original deposit! On the other hand, the bank's capital also loses value in the hands of the borrowers. Yet the banking system does not seem to specifically address this problem. For, legally speaking, the problem does not exist — one thousand today of any currency is legally one thousand tomorrow or ten years later, irrespective of any change in its purchasing power. But, admitting the reality, the banks do accommodate a compensation for the loss by adjusting the interest rate. The adjustment, however, is generally always in favour of the bank. This is unfair to both the depositor and the borrower.

In the case of a (Muslim) depositor who eschews interest, in rejecting the paid interest he also rejects the little compensation for inflation contained therein. This is as if he is being punished for his religious (or other) conviction, and for his desire to act on it. This is unfair. Therefore the third book — *Commercial Banking in the presence of Inflation* —

addresses the problem explicitly so that neither the banks nor the clients are dealt an unfair deal.

The book begins by asking simple questions such as what is inflation and how it is measured. It explains the relation between price, inflation and money — when the price of a product increases your money buys less of that product; inflation has eaten the value of your money. But since there are several products (and services), each with its own price, and since all prices do not vary at the same speed, there are innumerable rates of inflation. Again, since all people do not spend their money on the same things or to the same extent, different people experience inflation to different degrees. It concludes its second extensive chapter by saying, "… the common perception that there exists a single rate of inflation, and an appropriate method of measuring it, is not correct."

7.1 Measuring inflation on capital

Price indexes are constructed to indicate average price changes among a group of related products or services. The groupings may relate to specific industries, to those used by a specific group of people, to a specific geographical area, etc. These price indexes are then used as indicators (or measures) of inflation. Price indexes can also be constructed by the purposes for which people spend their money. The money people earn or posses are also used for different purposes — a portion of it (in many cases, all of it or most it) is used for daily consumption expenses; what is left over is saved for future use, or is invested. The popular price index called the cost of living index (also called consumer price index) measures the inflation on the former type of money. But the concern in this study is the other two types of money — that is, money that one may consider his savings, wealth or capital. After studying several popular measures of inflation, and showing that each one was

constructed for a specific purpose, the third chapter concludes by saying that none of those measures are appropriate for the purpose at hand, i.e. as a measure of inflation on capital. The study also brings out other essential characteristics, besides appropriateness, that any measure should posses in order to meet the requirements of the present purpose. These include uniqueness; consistency, continuity and reliability; timeliness; and legal and popular acceptance. None of the existing measures of inflation posses these qualities.

Historically people have stored their wealth in gold and silver. Banks, including the central banks and the IMF, too hold a major portion of their reserves in gold. In fact, until recent times gold and silver coins were used as medium of exchange — that is, as money. The British Pound and the US Dollar owe the prestige of their use as reserve currencies to their (now historical) guaranteed equivalence to a certain amount of gold, as much as to any other new cause. Even today, when people's trust ebbed as to the ability of the banking system to return their deposits or as to that of the government to guarantee the value of the currency, people resorted to gold to hold their wealth in, if it was possible. In times and places of high inflation, gold is seen as a good hedge against erosion of the value of wealth. The book cites several recent examples from different countries. At the end of a series of arguments, gold is found to be the best *store of wealth* when there is inflation. Consequently the *market price* of gold can be used as a *measure of inflation on wealth* (or capital). In Chapter 4, a measure specific to this purpose is designed, and its characteristics examined to see if it satisfied all the specified criteria. It does satisfy all the criteria. Furthermore, the effort and expenses necessary to set up this new measure is almost negligible, on account of the fact that only one commodity and its price need be monitored; all other measures involve

hundreds of prices. The interested reader may refer the book for details.

The new measure has been defined as the 13-week moving average of the previous 13 weekly average prices of a specified quality of gold at the local (meaning national) gold market, as determined by the country's Central Bank. This is the standard price of wealth for the current week. Its rate of change is the rate of inflation (or simply inflation) with respect to wealth (or capital). This measure, however, has a major hurdle to overcome if it is to be valid and useful in banking and financial transactions. That is, it needs to be legally recognised. This will need parliamentary legislation. If and when that happens it will be the legally accepted common measure of the rate of inflation on capital for the whole country, and one can use it straight away, both in official and private transactions.

7.2 Application to commercial banking

Inflation is a slow process that eats into capital imperceptibly. The damage occurs gradually over time, and the damage done during a short period of time is not worth bothering about. Therefore, in computing the compensation for capital erosion, one has to make a choice as to the time limit beyond which this damage requires attention. One month may be too short for inflation to make any substantial impact, and one year too long for someone to put his money away. Also a shorter time limit may bring in too many transactions under the scheme and cause too much computational work. Therefore a time limit of three months has been suggested for both deposits and advances. All accounts above this line will be maintained in gold-equivalents and all others in normal currency.

The analysis in this book has shown that the action necessary to counteract the effects of inflation is limited to only three areas: time deposits, medium- and long-term loans, and

government bonds. All the other areas of commercial banking operations can continue as at present. The latter involve the bulk of the work at a commercial bank, and the introduction of gold-equivalent scheme does not add to this load. Therefore introducing this effective method against inflation is much simpler than would appear at first. Furthermore, it is a general method and can be applied equally well in conventional banking as in interest-free banking.

How does it work? In theory, all deposits will be accepted and returned in terms of gold units, and all loans will be granted and collected in terms of gold units. In other words, all capital transactions will be in gold.[8] In practice, however, one has to deal in normal currency. This is where the gold price comes in — to compute the currency equivalent of the same amount of gold at the beginning of the term and at the end.

Using the rate of inflation on capital given by the gold price, one can compute the loss suffered by capital in currency units. For example, if the capital (deposit or loan) was 5000, and the rate of inflation (on capital) was 15 percent per annum, then the loss due to inflation in one year is 750 (= 0.15*5000). Thus, after one year, the inflation-compensated capital is 5750, in currency units. This is the amount the bank will return to the depositor, if the capital was a deposit. If it was a loan, the bank will collect this amount plus the other four components of the cost of borrowing[9] from the borrower.

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[8] In the time of the Prophet (peace be upon him) money was in gold and silver. So all the capital transactions too took place in gold or silver. We are following exactly the same practice that existed at the time of the Prophet, even though we arrived at it through a study of present-day conditions. Lest it be forgotten, until 1971, when the US government decided to close the "gold window", all currencies were anchored to gold, directly or indirectly.

[9] See section 5 above.

The important point to note here is that the compensation for inflation is computed at the time of withdrawal or repayment. Therefore, the prices used are *actually realised prices*. They are not predicted or expected future prices. Hence, there is *no uncertainly* in the computed values. What is computed is only what the capital really *did lose* due to inflation *while it was away* from the lender (depositor or bank).

When capital is so protected against inflation there is little sense in holding one's wealth in cash, or indeed in many other forms of property. Therefore, the opportunity this approach affords to bringing out idle capital into the banking system, and thus making it available for national development, is great. It deserves serious consideration by banks and governments, especially of the developing world.

7.3 Application to participatory financing

In the second book, a whole chapter has been devoted to the study of the effect of inflation on participatory financing. It has been recommended that, "... considering the [value] erosion of investor capital as part of project expenses, and reimbursing the amount to the investor (or rather to the project) before distributing the resulting profit/loss to the partners will form a better and more equitable approach." This amount was to be computed using the rate of inflation. But what that rate was and how it was to be estimated had been left unanswered. The inflation rate on capital developed in this volume can now be used as the rate of inflation required in participatory financing.

7.4 Government bonds

Governments issue bonds to obtain long-term loans from the public. The face value of the bond is guaranteed on maturity, and, since the bonds are bought on issue at less than

the face value, there is a return on them. Because they can be bought and sold easily, these are good liquid assets, especially for the banks. However, there is a problem when the economy is interest-free. The return is interest, and if one wished to avoid interest then he should buy the bond today at its face. But the face value realised on maturity would have lost part of its purchasing power due to inflation! Some have suggested that these bonds be issued on a profit-and-loss-sharing basis. But then such funds are invested by governments in non-profit projects (such as infrastructure, schools and hospitals) or in long-term projects (such as power or irrigation). The dilemma and the debate continue. The book suggests that the bonds be denominated in terms of gold-units. Then there will be no *riba*, for what is given and what is returned will be the same, in kind and amount; and the lender will not suffer the inroads made by inflation.

There is an interesting aside to the suggestion: "... many Muslim individuals and institutions will buy government bonds without any qualms about being involved in *riba*. The government too stands to gain, because they will now be paying less for the funds than before. But the other side of the coin is that the money now comes in with a moral string attached —with a patriotic or *fi-sabilillah* (for-God) motive— unlike in the conventional case where the motive is private gain — guaranteed positive return on capital. This puts the government under a moral pressure to use the funds properly and for good causes."

7.5 The model

The third book also includes a 27-page appendix, where the model used in the first and third books is given in its complete form and is fully explained.

8. Modular implementation

The system proposed in the three books can be considered as consisting of a number of modules. Each module is practically independent of the other. Therefore, one can tailor a system, consisting of one or more modules, depending on the specific circumstances of what is required, where it is required and who wants to implement it. The implementation can also be staggered over time. A few examples are considered in the next paragraphs.

The major modules are: 1) the full commercial bank module, 2) the participatory financing module, 3) the compensation for inflation module, and 4) the government bonds module. Within the first module there is a savings-and-loans sub-module, and within the second there are several options ranging from pure two-person *mudaraba* and small investment companies to large investment banks. Except the last module others do not need explicit changes in the laws of the country or of the banking business. Modules 1 and 2 can be implemented under existing banking and business laws. Module 3 will need new laws and Central Bank co-operation for strictly legal enforcement. However, it is possible to implement it by mutual agreement between the bank and its clients. Module 4 needs government action.

In the oil-rich Middle-eastern countries, and in many developed countries, inflation is negligible. Therefore the third and fourth modules are not of immediate importance. Module 1 can be implemented to provide a complete commercial banking system that is free of *riba*. These banks will offer all current accounts, savings and loan facilities. Loan facilities will include short-term financing, temporary overdrafts, bills of exchange, treasury bills and letters of credit. All that an existing conventional bank has to do to convert to an interest-

free one is to adopt the accounting system proposed in the first book and delete the pure interest component. This would also make all its dealings transparent.

Countries like Pakistan, Iran and the Sudan (where interest is prohibited by law and where inflation is also high) will have to implement all four modules to fully benefit from the proposed system. But the implementation can be done in stages, module by module.

Muslim communities living in non-Muslim countries, such as North America, Europe and India, may consider implementing the savings and loans sub-module of module 1 and some options of module 2.[10] Where the population is large, such as in India, they may even implement all the modules except the last (government bonds).

Modules 3 and 4 concern inflation. And inflation is no respecter of religious convictions or prohibitions — it affects all capital equally. As such these modules are of general applicability. Therefore they can be implemented, independently of other modules, by any country afflicted with inflation. That includes practically all developing countries.

Module 2 is a responsible form of financing. It is not the sole property of Muslims. Therefore it can be implemented (in any form of its several options) by any group of people concerned with where their money is invested and how their income is earned.

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[10] This case is fully addressed in two forthcoming publications, tentatively entitled: Savings and loans in small communities, and Participatory financing in small communities.

9. Conclusions

The three books under consideration have put forward a comprehensive banking and financing system. It has been developed to address primarily the needs and concerns of Muslims today in all parts of the world. Yet many of its components are of general applicability. It *avoids* almost all the pitfalls encountered by Islamic banking as practised today and successfully addresses many issues currently being debated. It offers sufficient flexibility to be tailored to suit a variety of situations. It is compatible with the conventional system, and uses many of the latter's tried and proved methods and procedures; thus avoiding any clash with the existing systems, and escaping re-inventing the wheel. Above all it is easy to understand, to explain, and to implement. As such it deserves serious consideration by the Muslim community as a whole, as well as by others interested in a transparent system of banking and a responsible form of financing.

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Al-Qur'an II 274-281

274. Those who spend their wealth by night and day, by stealth and openly, verily their reward is with their Lord, and there shall no fear come upon them neither shall they grieve.

275. Those who swallow usury cannot rise up save as he ariseth whom the devil hath prostrated by (his) touch. That is because they say: Trade is like usury; whereas Allah permitteth trading and forbiddeth usury. He unto whom an admonition from his Lord cometh, and (he) refraineth (in obedience thereto), he shall keep (the profits of) that which is past, and his affair (henceforth) is with Allah. As for him who returneth (to usury) — Such are rightful owners of the Fire. They will abide therein.

276. Allah hath blighted usury and made almsgiving fruitful. Allah loveth not the impious and guilty.

277. Lo! those who believe and do good works and establish worship and pay the poor-due, their reward is with their Lord and there shall no fear come upon them neither shall they grieve.

278. O ye who believe! Observe your duty to Allah, and give up what remaineth (due to you) from usury, if ye are (in truth) believers.

279. And if ye do not, then be warned of war (against you) from Allah and His messenger. And if ye repent, then ye have your principal (without interest). Wrong not, and ye shall not be wronged.

280. And if the debtor is in straitened circumstances, then (let there be) postponement to (the time of) ease; and that ye remit the debt as alms-giving would be better for you if ye did but know.

281. And guard yourselves against a day in which ye will be brought back to Allah. Then every soul will be paid in full that which it hath earned, and they will not be wronged.

Al-Qur'an III 130

130. O ye who believe! Devour not usury, doubling and quadrupling (the sum lent). Observe your duty to Allah that ye may be successful.

Al-Qur'an IV 161

161. And of their taking usury when they were forbidden it, and of their devouring people's wealth by false pretences. We have prepared for those of them who disbelieve a painful doom.

Al-Qur'an XXX 39

39. That which ye give in usury in order that it may increase on (other) people's property hath no increase with Allah; but that which ye give in charity, seeking Allah's countenance, hath increase manifold.

(Al-Qur'an. Translated by Marmaduke Pickthall.)

HADITH

Abdullah (b. Masud) (May Allah be pleased with him) said that Allah's Messenger (May peace be upon him) cursed the one who accepted interest and the one who paid it. I asked about the one who recorded it, and the two witnesses to it. He (the narrator) said: We narrate what we have heard.

Jabir (May Allah be pleased with him) said that Allah's Messenger (May peace be upon him) cursed the acceptor of interest and its payer, and the one who records it, and the two witnesses; and he said: They are all equal.

(Sahih Muslim Hadith nos. 3880 and 3881.
Translated by Abdul Hamid Siddiqi.)

ABOUT THE BOOK

The author of this booklet is also the author of the three titles given below. Each of them is self contained, treats a specific topic, and provides a new methodology. The present work describes how the three books, taken together, offer a comprehensive banking and financing system that addresses the needs and concerns of Muslims today. Each book provides one or more independent modules of the system, and each module can be implemented alone or in combination with others depending on the circumstances and time frame. Many of the modules are of general applicability — being Muslim is not a prerequisite. Some modules contain several options to address different field conditions. Consequently, the system spans so wide a spectrum of circumstances that practically every country and every community can find a combination that will suit its particular requirements.

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through
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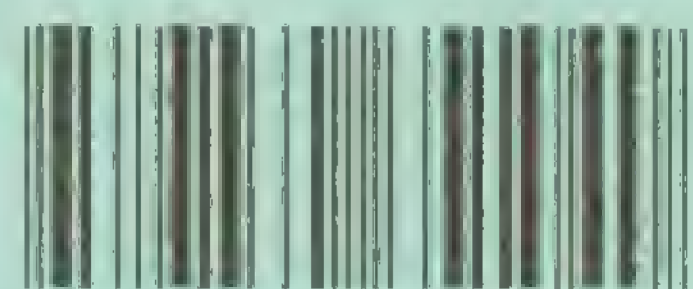
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